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IN THE
SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1982

CAROL W. HILTON, et al.,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States:

Carol W. Hilton, et al.,[1] the Petitioners herein, respectfully pray that a Writ of Certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Ninth Circuit filed in the above-entitled case on March 8, 1982.

QUESTIONS PRESENTED

1. Are the Petitioners entitled to deduct on their individual federal income tax returns their distributive shares of partnership losses, consisting of the excess of deductions for interest expense, management fees, and depreciation over the amount of the rental income, from the property owned by the partnership in which they were partners?
2. Should the form of the transaction by which the Petitioners' partnerships: (1) purchased, through a nominee corporation, real property improved with a newly constructed department store; (2) leased the

1. In addition to Carol W. Hilton, taxpayers who were Appellants in the Ninth Circuit Court of Appeals and are Petitioners herein are Edward R. Bloomquist, Lila M. Bloomquist, DeSales G. DuVigneaud, Lola F. DuVigneaud, Raymon E. Lawton, Rosellen M. Lawton, Theodore E. Marvis, Phyllis H. Marvis, DeVere W. McGuffin, Anetta T. McGuffin, Philip E. Hilton, Barbara J. Hilton, Louis L. Smith, Marguerite M. Smith, Chester D. Wahlen, Eleanor J. Wahlen, Daniel M. Martin and Ana Y. Martin.

property back to the seller; (3) financed the purchase by sale of the nominee corporation's corporate notes to five insurance companies; and (4) secured repayment of the notes by execution of a mortgage and assignment of the lease, be recognized for tax purposes?

TABLE OF CONTENTS

	Page
Questions Presented	i
Table of Authorities	iii
Opinions Below	1
Jurisdiction	2
Statutes Involved	2
Statement of the Case	4
Reasons for Granting the Writ	7
1. The Decision Below Is In Conflict With the Prior Decisions Of This Court	**7**
A. The Lyon case is factually on point and requires a decision in favor of the Petitioners.	**9**
B. The legal standards set forth in the Lyon case are applicable here and are satisfied in the present case	**16**
2. The decision Below Raises Significant and Recurring Problems Concerning the Uniform Application of the Federal Income Tax Laws to Widely Used Commercial Sale-Leaseback Transactions	**24**
Conclusion	29

TABLE OF AUTHORITIES

Cases **Page**

American Realty Trust
498 F.2d 1194 (4th Cir. 1974) 24

Bolger v. Commissioner,
59 T.C. 760 (1973)..... 25, 28

Dunlap v. Commissioner,
74 T.C. 1377, (1980), reversed and remanded on unrelated issues, 670 F.2d 785 (8th Cir. 1982) 25-28

Estate of Franklin v. Commissioner,
544 F.2d 1045 (9th Cir. 1976) 8

Frank Lyon Co. v. United States,
435 U.S. 561 (1978)..... 8, 11, 14, 16, 19, 20, 21, 23, 24

Frank Lyon v. United States,
536 F.2d 740 (8th Cir. 1976) reversed
435 U.S. 561 (1978)..... 14, 18, 24

STATUTES

Page

Internal Revenue Code (26 U.S.C.)
Section 162 (a) (1)..... 2

Internal Revenue Code (26 U.S.C.)
Section 163 (a)..... 2

Internal Revenue Code (26 U.S.C.)
Section 167 (a)..... 2

Internal Revenue Code (26 U.S.C.)
Section 212 (1), (2) 2

Internal Revenue Code (26 U.S.C.)
Section 1254 (1)..... 2

APPENDICES OF
PETITION FOR A WRIT OF CERTIORARI

TABLE OF CONTENTS

Page

APPENDIX A:

Opinion of the United States Court of Appeals for the Ninth Circuit, Dated March 8, 1982 2

APPENDIX B:

Opinion of the United States Tax Court, dated May 19,1980 16

APPENDIX C:

Decisions of the United States Tax Court, dated August 12, 180 121

APPENDIX D:

Order of the United States Court of Appeals for the Ninth Circuit Denying Petition for Rehearing, dated April 28, 1982 134

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PETITON FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

OPINIONS BELOW

The Opinion of the Ninth Circuit Court of Appeals is reported at 671 Federal Reporter 2d 316 (March 8, 1982) and is printed in Appendix A hereto. The Opinion of the United States Tax Court is reported at 74 United States

Tax Court Reports 305 (May 19, 1980) and is printed in Appendix B hereto. The decisions entered pursuant to the Opinion of the United States Tax Court are printed in Appendix C hereto.

JURISDICTION

The Opinion of the United States Court of Appeals for the Ninth Circuit was filed on March 8, 1982. A timely petition for rehearing and suggestion for rehearing in banc was denied by Order filed April 28, 1982 (Appendix D). The jurisdiction of the Supreme Court is invoked under 28 U.S.C. §1254(1).

STATUTES INVOLVED

This case involves Sections 162(a)(1), 163(a), 167(a), and 212(1) and (2) of the Internal Revenue Code (26 U.S.C.), which provide as follows:

Section 162. Trade or business expenses.

(a) In general.

> There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including — (1) a reasonable allowance for salaries or other compensation for personal services actually rendered . . .

Section 163. Interest

(a) General rule.

There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

Section 167. Depreciation.

(a) General rule.

There shall be allowed as depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) — (1) of property used in the trade or business, or (2) of property held for the production of income . . .

Section 212. Expenses for production of income.

In cases of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year — (1) for the production or collection of income; (2) for the management, conservation, or maintenance of property held for the production of income . . .

STATEMENT OF THE CASE

This petition arises from United States Tax Court proceedings which upheld the disallowance by the Commissioner of Internal Revenue of deductions for partnership losses taken by Petitioners on their Federal Income Tax Returns. Following notices of deficiency by the Commissioner, Petitioners timely filed petitions for redetermination of deficiency in the Tax Court.

The ultimate source of the losses claimed by Petitioners was a partnership known as Medway Associates (hereinafter "Medway"). Medway was a participant in a multi-party sale-leaseback transaction by which it acquired ownership of real property improved with a department store facility in Bakersfield, California which was leased to Broadway-Hale Stores, Inc. (hereinafter "Broadway"), a department store chain with retail locations in California and Arizona.

Broadway had earlier acquired a twelve acre parcel of unimproved land, at a cost of $198,136, which it intended to incorporate into a proposed shopping center in a suburban area of Bakersfield. (Appendix B, p.22).. In April, 1965, Broadway entered into an agreement with Sears-Roebuck & Company and a development corporation for the construction of Valley Plaza Shopping Center. (Appendix B, P. 24). As a result of loan and credit agreements with its banks, Broadway had a ceiling on the dollar amount of debt which it could incur and the total value of its property which could be mortgaged. Con-

sequently, Broadway had for several years followed a practice of selling its newly constructed stores immediately after completion and leasing them back pursuant to long term leases. When Broadway desired to construct and sell a new store it would contact the Real Estate Department at Wood, Struthers & Winthrop (hereinafter "Wood, Struthers"), a New York Exchange broker and investment company, to find a potential purchaser of the store and to arrange financing for the purchaser. (Appendix C.p. 17-18).

A primary source of financing used by Wood, Struthers for its purchasers was major insurance companies. The insurance companies were subject to limitations on the amount of their funds that could be used for direct real estate mortgage loans as well as restrictions on the percentage of the purchase price of real estate that they could finance in any particular transaction. However, these restrictions did not apply to the purchase by the insurance companies of corporate notes. Therefore, rather than have the individual investors who were to own the property borrow from the insurance companies as individuals or in partnerships to make the purchase, Wood, Struthers would form a nominee corporation on behalf of the eventual individual owners of the property. The nominee corporation would sell its corporate notes to the insurance companies and secure its payment on the notes by a mortgage of the real property purchased with the proceeds. (Appendix C, p. 17-18). The transaction would be structured so that the sale of the corporate notes, the

purchase of the real property, the execution of the mortgage, and the leaseback of the property occurred simultaneously, followed immediately by the transfer from the nominee corporation of title to the real property subject to the mortgage obligation, to the intended owners, the individual investors. (Appendix C. p. 21).

In the case at issue, Broadway arranged and paid for the construction of a three-story, 155,000 square foot, retail department store on the Bakersfield site (the land and building hereinafter collectively referred to as "the Property"). Broadway's cost for the land and construction of the improvements was $3,332,833.57. (Appendix B, p. 25). Fourth Cavendish, the corporation formed by Wood, Struthers to serve as nominee in this transaction, sold $3,137,500 of its five and one-eighth percent, 30-year corporate notes to five major insurance companies. The repayment schedule provided for a 10 percent balloon payment at the end of 30 years. Fourth Cavendish then purchased the store and underlying land for a total agreed consideration of $3,137,500. (Appendix B, p.27).

As part of the transaction, Fourth Cavendish also leased the store and underlying land back to Broadway for an initial term of 30 years at an annual rental of $198,603.75. The lease also provided for three renewals at the option of Broadway for terms of 23, 23, and 22 years at annual rentals of $47,062.50, $31,375.00, and $31,375.00 respectively. The rental payments for the first 30 years were only slightly greater than the payments due pursuant to

the corporate notes. Broadway had no unconditional rights of repurchase under the lease. (Appendix B, p.40-42).

Fourth Cavendish also executed a mortgage indenture and deed of trust on the store and land in favor of the insurance companies' appointed trustees to secure repayment of the corporate notes. As additional security for repayment, Fourth Cavendish assigned its interest in the Broadway lease to the trustees. Fourth Cavendish simultaneously transferred the store and land to the Medway partnership, by grant deed. Medway Associates paid no consideration to Fourth Cavendish for the transfer, inasmuch as Fourth Cavendish was acting merely as the nominee of Medway, the intended purchaser and owner. (Appendix B, p. 28-29).

During the tax years at issue, Medway reported rental income for the lease payments received from Broadway and took deductions for interest on the note payments to the insurance companies and depreciation on the improvements as owner thereof. The excess of these deductions over rental income resulted in partnership losses which were distributable to the Petitioners through other partnerships.

REASONS FOR GRANTING THE WRIT

1. The Decision Below Is In Conflict With The Prior Decisions Of This Court.

At the outset it should be noted that the brief, per curiam opinion of the Ninth Circuit affirms the decision of

the Tax Court on the basis of the reasoning of the Tax Court opinion, with only two minor modifications. (Appendix A, p. 4-5). Therefore, primary reference in this Petition will be made to the opinion of the Tax Court. (Appendix B).

The instant case is not distinuishable in any significant way from the decision by this Court in **Frank Lyon Co. v. United States,** 435 U.S. 561 (1978). Nevertheless, the Tax Court only gave lip service to the **Lyon** opinion and instead focused its attention on **Estate of Franklin v. Commissioner,** 544 F.2d 1045 (9th Cir. 1976), which has little or no applicability to the present case. Appendix B, p. 87). Ultimately, however, after a lengthy exercise in trying to apply **Franklin**, the Tax Court finally had to confront the facts of **Lyon** as they apply to the present case and noted:

> Having so analyzed petitioners' lack of potential for economic gain, we must nevertheless confront the question of how petitioners' position differs, if it does, from that of the buyer-lessor in the **Frank Lyon** case. (Appendix B, p. 105).

Under any objective comparison of the facts, the answer must be that the taxpayers' position here is even stronger than the position of the buyer-lessor in **Lyon.** However, neither the Tax Court nor the Ninth Circuit ever really confronted or applied the tests set forth in **Lyon** for judging a sale-leaseback, but rather found **Lyon** disting-

uishable on factual grounds without legal significance. The practical effect of the Tax Court's opinion and the Ninth Circuit affirmance thereof is to circumvent the most significant sale-leaseback decision from this Court in almost forty years.

It is the petitioners' position that (1) the result of **Lyon** is controlling in the present case because of the similarity of the facts and because, if anything, the present transaction transferred more of the traditional rights of an owner-lessor to the petitioners than the transaction in **Lyon;** and (2) **Lyon** sets forth the applicable legal and factual tests for determining whether a sale-leaseback of the type involved in the present case should be recognized for tax purposes, rather than the tests enunciated by the Ninth Circuit in **Franklin**, and the sale-leaseback in the present case qualifies for recognition as a valid sale-leaseback under the tests of **Lyon.**

A. The Lyon case is factually on point and requires a decision in favor of the Petitioners.

In **Lyon,** this Court decided in favor of the petitioner-taxpayer on facts similar in all essential respects to the facts of the instant case. Moreover, in several respects, the facts herein present an even stronger case than those in **Lyon** for upholding the validity of the sale-leaseback, since the **Lyon** transaction had several characteristics of a two-party financing transaction not present before the Court in this case.

In both **Lyon** and the present case, the seller-lessee

wanted to construct a new building for its business. In both cases, the seller-lessee was prevented from financing the cost of the building itself by legal and economic restrictions. In both cases, the buyer-lessors financed the purchase price for the newly constructed buildings by selling corporate notes to insurance companies. The notes were secured by mortgage indentures and deeds of trust on the property. The buyer-lessors both leased the property back to the seller-lessees on a net lease basis, at rentals which were determined by reference to the terms of the mortgages and were just sufficient to make the payments on the notes. The initial lease terms were 25 years in **Lyon** and 30 years in the present case, with renewals, at reduced rents, which could extend the lease terms to 65 and 98 years, respectively. In both cases, the leases were assigned as additional security.

The differences between the terms of the two transactions favor the transaction in the present case, since the transaction herein has more characterisitics of a genuine multi-party transaction, and the Petitioners herein acquired more of the characteristics of a traditional lessor, the two tests stated by this Court for determining a valid sale-leaseback, than the taxpayer in **Lyon**. In **Lyon**, the seller-lessee negotiated directly with financing sources and eventually obtained a loan commitment itself from New York Life Insurance Company. Frank Lyon Co., the eventual buyer-lessor, was approved by the lender only subsequently. In the case herein, Wood, Struthers, an independent third party, obtained the financing without

participation by Broadway.

In **Lyon,** the taxpayer acquired ownership of only the building and had a lease on the underlying land for only 76 years. Herein, Broadway parted with, and the Petitioners acquired ownership of , both the building and the underlying land. If the seller in **Lyon** exercised all of its renewal options under the building lease, the taxpayer would have had the use of the building unencumbered by the lease for only ten years, at a point 65 years in the future. The taxpayer's control of the building would end at that time unless it could renegotiate the gound lease with Worthen. Nonetheless, this Court noted favorably the fact that if the building lease were **not** extended, the taxpayer would be the full owner of the building, free to do with it as it chose. 435 U.S. at 567, n.3 and 583. The present facts are even stronger in favor of the taxpayer. Even if Broadway exercises all of its renewal options under the lease, the Petitioners herein will acquire unqualified use of the land and building after 98 years, and earlier if Broadway does not renew at 30, 53 or 76 years. Moreover, the Petitioners will own **both** the land and the building in fee simple and could convey clear title to both to a prospective buyer.

In **Lyon,** the seller-lessee had the unqualified right to repurchase the building at various times at a price equal to the unpaid balance on the notes plus the $500,000 down payment of Lyon plus six percent compounded on the $500,000. The seller-lessee would receive any award realized as a result of destruction or condemnation of the

building in excess of the mortgage and the $500,000. In this case, Broadway does not have any unqualified right to repurchase. It can make offers to repurchase upon destruct or condemnation, but the offers are rejectable. Moreover, Petitioners are entitled to the proceeds of insurance and condemnation awards in excess of the mortgage if the offer to purchase is rejected.

Based upon the facts in **Lyon,** which are markedly similar to those in the instant case, this Court concluded that there was a valid sale-leaseback transaction and that the taxpayer-buyer-lessor was entitled to deduct depreciation and interest. As noted above, Petitioners in this case are in many respects in an even stronger position than the taxpayer in **Lyon.** Despite the obvious similarity of the facts in **Lyon** to those of the present case, the Tax Court and the Ninth Circuit erroneously refused to apply the test of **Lyon** to the present case, even as additional support or as an alternate ground for their decision. The attempt of the Tax Court opinion to distinguish **Lyon** merely by stating purported factual distinctions, some of which are misstatements of the facts themselves, without showing the legal significance of the purported differences is legally insufficient. (Appendix B, p. 107-110).

The Tax Court first noted that the initial term of the

lease in **Lyon** was sufficient to amortize the entire balance of the underlying mortgage, whereas in this case a 10 percent balloon would remain. (Appendix B, p. 108). However, the 10 percent balloon in the present case is nothing more than a deferral of the down payment from the beginning of the transaction to the end, which constitutes an additional economic benefit to the Petitioners. If anything, the presence of a balloon payment which must be made by the Petitioners emphasizes the genuine multi-party nature of the transaction, since Broadway has no power to prevent a default on the notes and the mortgage simply by making lease payments. Independent action and payment by the Petitioners is required to prevent loss of the property to the trustees for the insurance companies. Moreover, the Petitioners' payoff of 90 percent of the notes by virtue of the lease payments constitutes a substantial equity investment in the property, entitling Petitioners to the tax attributes of ownership. Finally, the Ninth Circuit opinion, while not explicitly disavowing reliance on this factual distinction, states that the presence of a balloon payment should not be considered a negative factor. (Appendix A. p. 5).

The Tax Court herein also stated that the rent in **Lyon** was fair rental value for the property and was substantial after the initial lease term. (Appendix B, p. 108). However, in **Lyon** as in this case, the rental payments on the primary term were substantially equal to the principal and interest payments due under the financing. In addition,

the lease terms for the renewal periods are substantially identical, and perhaps even more favorable to the Petitioners herein, given the substantial ground rent increases in **Lyon**. In any event, fair rental value is not relevant in these cases since the issue, as emphasized by this Court, is the taxpayer's investment in the property. This investment is established by the payoff of the notes, not the rental terms of the property. **Frank Lyon Co. v. United States,** 435 U.S. at 581.

The Tax Court also argued that **Lyon** is distinguishable on the basis that the taxpayer in **Lyon** made a down payment out of its own funds for the purchase. (Appendix B, p. 108). However, the Tax Court failed to recognize the totally ephemeral nature of the alleged down payment in **Lyon.** As the Eighth Circuit Court of Appeals recognized in its opinion, Lyon's $500,000 down payment was matched by a $500,000 loan from Worthen. **Frank Lyon Co. v. United States,** 536 F.2d 746, 748 n. 1 (8th Cir. 1976), reversed 435 U.S. 561 (1978). Moreover, when New York Life, the lender, refused to accept a lease providing for lower rents to Worthen as security, Lyon compensated Worthen for the rent increase by paying a three percent bonus interest rate on the loan over and above the going interest rate for such loans. The one year note which documented Worthen's loan to Lyon had been renewed at various times prior to the trial and Lyon had made no payment on the principal. **Id.**

The Tax Court also asserted that the taxpayer in **Lyon** stood to realize a substantial gain in the event the seller's

repurchase option was exercised. (Appendix B, p. 108). This interpretation of **Lyon** is obviously fallacious since Worthen's repurchase option was only for the amount of Lyon's down payment plus a six percent return. On the other hand, Petitioners in this case ultimately will own the building and land in fee simple unencumbered by the lease, with full power to sell the same for whatever price it will bring on the open market. It is a strange logic which allows the Tax Court to take the limitations found in **Lyon** on investment return, imposed by the lessee's option, and turn them into a supposed opportunity for gain to the taxpayer. It is an even stranger logic which asserts that an owner of leased property whose return on investment is limited by the seller's automatic option to reacquire the property is in a better position than an owner who has no restrictions on his ability to sell the property at the end of the lease.

The Tax Court also tried to distinguish **Lyon** on the grounds that the taxpayer in **Lyon** was a substantial corporate entity which actively participated in the negotiating of the transaction, whereas in this case the Petitioners acquired their interest in the property through the financing corporation. (Appendix B, p.108-109). Again, however, the Tax Court misstated the facts of the **Lyon** case. In **Lyon,** the seller-lessee, not the taxpayer, actually negotiated the entire arangement with New York Life and then itself marketed the interest to be assumed by a financing corporation, which gives the appearance of only a two-

party transaction. 435 U.S. at 564. In the present case, the transaction was negotiated for Wood, Struthers by one of its partners, Roderick Cushman, who dealt with Broadway and the insurance companies on behalf of the ultimate owners, which included himself as a general partner of Medway, as well as the Petitioner herein. (Appendix B, p.18-19, 23). The substantiality of the Lyon Company as a corporation is conceivably relevant only on the issue of whether it had substantial assets to secure the recourse loan. But, substantial assets would be relevant only if there were personal liability on the mortgage. On this point, the Tax Court admitted that given the commercial realities of real property transactions the lack of personal liability in the present case is without significance. (Appendix B, p. 109-110). Therefore, the substantiality of the corporate entity is also unimportant.

Thus, the facts of this case present even stronger support than the facts in **Lyon** for the taxpayer's position that they acquired an equity interest in the property and are entitled to the incident tax benefits. There is no factual distinction of any legal significance, and the Tax Court decision and Ninth Circuit affirmance are contrary to this Court's ruling in **Lyon** and should be reversed.

B. The legal standards set forth in the Lyon case are applicable here and are satisfied in the present case.

Even if the result of the **Lyon** case did not auto-

matically control the result in the instant case because of factual differences, the transactions are similar enough that the tests enunciated by this Court in that case are binding on the Tax Court and the Ninth Circuit in judging the viability of the Petitioners' sale-leaseback transaction herein. The Tax Court and the Ninth Circuit substantially ignored these tests.

The difficulty for the taxpayers and the three courts which reviewed the sale-leaseback transaction in the Lyon case was that it was not possible to specify with certainty who would actually end up with possession of the building upon expiration of the leasehold and security interests. Although the Lyon Company appeared to be the owner of the building, it was also true that the seller-lessee had an option to repurchase the building at various times and that the option could be exercised by, in essence, reimbursing the Lyon Company for its investment in the property plus interest. Further problems were created by the fact that the seller-lessee owned the underlying real property, and the ground lease on the real property would expire shortly after the lease term on the building, thereby again, giving the seller-lessee control over the building. Thus, the taxpayer's ultimate ownership interest in the building was seriously circumscribed and factually might never come into being.

The less than certain nature of Lyon's ultimate ownership of the building had been focused on by the Eighth Circuit in reaching its decision in favor of the Government. Factually, the Eighth Circuit emphasized Worthen's option

to re-purchase the building, the timing of that option, and the tying of the option price to Lyon's actual cash investment in the property. **Frank Lyon v. United States,** 536 F.2d 746, 749 (8th Cir. 1976). The taxpayer's argument was that it could not be assumed that Worthen would exercise the option to purchase, thereby reimbursing Lyon for its initial investment, but retrieving the building. **Id** at 751-52. The Eighth Circuit in finding in favor of the Government, offered the following reason among others:

> The bank retained ultimate control over the disposition of the building through its various options for 65 years and its ownership thereafter of the land upon which the building rested. 536 F.2d at 752.

The problem concerning the ultimate ownership of the property which was focused on by the Eighth Circuit was also emphasized by this Court in its opinion. The majority of the Court used the ultimate ownership interest of Lyon in the building, however slight, as a buttress for its argument:

> This, of course, is on the assumption that Worthen exercises its option to extend the building lease. If it does not, Lyon remains liable for the substantial rents prescribed by the ground lease. This possibility brings into sharp focus the fact that Lyon, in a very practical sense, is at least the ultimate owner

> of the building. If Worthen does not extend, the building lease expires and Lyon may do with the building as it chooses. **Frank Lyon Co. v United States,** 435 U.S. at 567, n.3.

This Court further noted:

> [The] inescapable fact that if the building lease were not extended, Lyon would be the full owner of the building free to do with it as it chose . . . 435 U.S. at 583.

Because of the ambiguity regarding Lyon's ultimate control of the reversion, this Court, in reaching its conclusion, examined numerous factors. Ultimately, however, this Court distilled its application of legal standards to the factual situation before it into two alternate and equivalent tests. First:

> [W]here, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax independent considerations, and is not shaped solely by tax avoidance features, the Government should honor the allocation of rights and duties effectuated by the parties. 435 U.S. at 583-84.

Or put even more simply:

> Expressed another way, so long as the lessor retains significant and genuine attributes of

> the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes. 435 U.S. at 583.

The most significant and genuine attribute of the traditional lessor status is retention of control over the reversion of the property. If the lessor retains control of the reversion, then he bears the risk of loss if the property declines in value but he also stands to benefit if the property increases in value. When it is uncertain whether, or to what extent, the nominal lessor has retained the reversion to the property, then the multiple factor approach used by this Court in **Lyon** to review all of the factors, significant and insignificant, is necessary. Where, however, it is clear that the lessor has retained that reversion, the ultimate legal test of the **Lyon** case is satisfied and no further inquiry is required. In the present case, the problem of determining ultimate ownership of the property is not present. The Petitioners will unquestionably ultimately possess the building and the underlying land free and clear of the lease of Broadway and the mortgage of the insurance companies at some definite point in the future.

When the lease expires, Petitioners will be free to market the property, lease the property, operate the property, or otherwise do with it as they please. If the property has declined in value, Petitioners will have suffered that loss. If the property has increased in value, Petitioners will be entitled to that benefit. Even before

expiration of the Lease, if interest rates were to decline, the Petitioners would be able to refinance the mortgage obligations and retain any benefits thereof. Because they control the reversionary interest, Petitioners have retained the significant and genuine attributes of traditional lessor status. Even the dissent in **Lyon,** implies that under such circumstances a genuine sale-leaseback transaction exists and the buyer-lessor should be treated as the owner of the property for tax purposes. 435 U.S. at 584.

The alternate legal standard set forth by this Court is also met by Petitioners. First, the instant transaction constitutes a genuine multi-party transaction for a variety of reasons. The inescapable fact that Petitioners will ultimately own the property outright mandates that they be viewed as a party to the transaction. Obviously, the transaction cannot be simply between Broadway and the insurance companies if, at some point in the future, by virtue of the transaction, neither has any interest in the property. In addition, the entire transaction was assembled and negotiated on behalf of the Petitioners by Cushman, who was himself one of the ultimate owners of the property as a partner in Medway. This is not a case of a simple two-party transaction negotiated between Broadway and the insurance companies. Fourth Cavendish was not created simply for the convenience of Broadway and the insurance companies, but rather to pass title to the Petitioners who are the ultimate owners of the property.

The transaction also has the economic substance of a

sale and lease-back. Broadway has parted with all ownership interests, both present and reversionary; it possesses the property under the restrictions of a lessee for a definite term only; its economic benefit from the Property is limited to the current income it can produce over and above its rental obligation; Broadway has no unconditional rights of repurchase and is not building up any equity in the property. The insurance companies likewise have no equity interest in the property, and their only economic interest is that of a lender and mortgagee with a fixed return. The Petitioners have economic ownership of the Property; they are entitled to the rents stated in the Lease; they are entitled to the benefits of any refinancing; they are, in general, entitled to condemnation proceeds in excess of those amounts necessary to restore the Property or to pay off the mortgage; and they will benefit from the value of the land and building when the lease to Broadway expires.

The transaction was not structured as a sale-leaseback with a nominee corporation and individual investors because of tax avoidance features, but because of tax independent considerations encouraged by business realities, namely Broadway's loan restrictions, the insurance companies real estate loan restrictions, and the lower interest and rental rates available if corporate notes were used by the Petitioners to finance the purchase price. The business reality to the individual Petitioners was that ordinarily they would never have had the ability or credit

standing to acquire ownership of so large and valuable a piece of commercial property outside the context of the present sale-leaseback transaction, where their purchase price can be financed out of the rental proceeds. The labels of owner-lessor, seller-lessee, and lender all mesh with reality and have real non-tax meaning. In addition, the parties intended to enter into a genuine sale and leaseback, which is an important factor, as pointed out in **Lyon,** 435 U.S. at 578-579. In fact, because of the loan restrictions on Broadway and the legal restrictions on the insurance companies, it was absolutely critical to all parties that the transaction be a true lease. (Appendix B. p. 83-84).

The factual tests of the **Lyon** case were developed to determine who ultimately owns the property and controls the reversion. That question should not be in dispute in this case. Petitioners have total control over the reversion and will ultimately possess the property free and clear of any interest of the lessee or lender. In any event, considering the **Lyon** legal tests, the ultimate ownership interest of the Petitioners meets all of the tests and requires that the Commissioner honor the parties' structuring of the transaction and recognize Petitioners' ownership of the property. The opinions of the Tax Court and the Ninth Circuit are in error and should be reversed, since they directly contradict the standards set forth by this Court in **Lyon** and ignore the reality of Petitioners' ownership of the property.

The conflict between the Opinion of the Ninth Circuit Court of Appeals in the present case and the decision of this Court in **Lyon** is sufficient to justify the grant of certiorari; however, it is also worth noting that the Opinion of the Ninth Circuit herein is also in conflict with the decision of the Fourth Circuit Court of Appeals in **American Realty Trust,** 498 F.2d 1194 (4th Cir. 1974). The Fourth Circuit in **American Realty Trust** upheld the validity of a long-term sale-leaseback and found that the buyer-lessor had acquired ownership interest which entitled it to depreciation deductions. A similar conflict between the Eight Circuit Court of Appeals' decision in **Frank Lyon Co. v United States,** 536 F.2d 746 (8th Cir. 1976), and the Fourth Circuit's decision in **American Realty Trust** was the basis for this Court's granting of certiorari in **Lyon. Frank Lyon Co. v. United States,** 435 U.S. 561, 572 (1978).

The conflicts above justify the grant of certiorari to review the judgment and opinion below.

2. **The Decision Below Raises Significant and Recurring Problems Concerning the Uniform Application of the Federal Income Tax Laws to Widely Used Commercial Sale-Leaseback Transactions.**

The sale-leaseback transaction is a common occurrence in modern real estate and business transactions. For a variety of business reasons, companies are increasingly opting to sell their facilities and lease back the premises

rather than maintain ownership. The sale-leaseback transaction frequently offers investors an opportunity to purchase real property with the prospect of long term investment returns and the benefit of reduction of the headaches of day-to-day management.

The frequency of use of this type of transaction and the difficulties in determining the federal income tax effect to the parties involved are reflected in the increasing number of sale-leaseback cases that have reached the Courts. In addition to the present case and the **Lyon** case, other examples of cases involving long-term sale-leasebacks are: **Bolger v. Commissioner,** 59 T.C. 760 (1973) and **Dunlap v. Commissioner,** 74 T.C. 1377 (1980) reversed and remanded on unrelated issues, 670 F.2d 785 (8th Cir. 1982). It is important that the federal laws be administered fairly and consistently in order that taxpayers can plan their business and investment transactions with some degree of certainty as to the tax effects. After this Court rendered what must be a landmark decision in this area of tax law in the **Lyon** case, taxpayers had the right to expect that the Tax Court and the Courts of Appeal would follow the **Lyon** decision and render consistent decisions in cases involving similar transactions. However, the Tax Court is not even rendering consistent decisions in cases before it that are substantially identical to each other. In fact, the present case illustrates that the Tax Court has not even been consistent in deciding whether the **Lyon** case is the controlling authority to be applied to such cases. This inconsistency is illustrated by comparing the present case

to **Dunlap**, decided by the Tax Court just four months after its decisions herein. In **Dunlap**, on substantially identical relevant facts, the Tax Court reached a totally opposite conclusion from that reached herein and did so by applying the tests of **Lyon**.

In **Dunlap**, Safeway Stores designed and built to its own specifications a division office, warehouse and distribution center in El Paso, Texas. 74 T.C. at 1400. Title to the property was conveyed to a single purpose financing corporation designed to accomodate the Texas insurance and usury laws. The Tax Court found that the corporation was specifically organized to acquire title to the property, secure financing of the purchase price, lease the property back to Safeway, and transfer title to the property and lease agreement to individual investors. **Id.** at 1401.

The financing corporation solicited and obtained investors, including the Dunlaps. The investors purchased the property by making an approximate four percent down payment and financing the balance with notes issued by the financing corporation. The notes were secured by a first deed of trust on the property and assignment of the Safeway lease. The lease was a triple net lease and provided for rent payments in the amount necessary to cover principal and interest on the notes and yearly management fees. **Id.** at 1401-07.

Under the lease, Safeway was required to make an offer to purchase the property under certain circumstances by

paying an amount sufficient to pay off the outstanding loan balances. **Id.** 1408-09. The lease also provided for an initial 25 year term with renewals for six additional five year terms, each at approximately one-third of the initial rent. **Id.** at 1407. The Commissioner contended, as he did in this case, that the sale-leaseback was a sham entered into for tax losses, that the transaction was not entered into for profit, and that the transaction was in reality a two-party financing arrangement. **Id.** at 1432.

The Tax Court concluded that the taxpayers were entitled to depreciation deductions, although they had no personal liability on the purchase mortgage, the mortgage would become due if Safeway terminated the lease by purchase of the facility. Safeway's rent approximated the ments to the investors, Safeway's rent approximated the principal and interest payments due on the notes plus the management fee, and the Dunlaps were aware of the tax consequences of their investment when they entered into the transaction. The Court emphasized that whether Safeway exercised its rights to renew the lease or not, the taxpayers would eventually own the property free of the lease with the ability to sell the property or put it to another use. 74 T.C. at 1437. Similarly here, the petitioners will ultimately own the department store and underlying property in a fast growing suburban area of Bakersfield, Californ[illegible] free of the lease, with the ability to sell the property or use it as they see fit.

The only distinction offered by the **Dunlap** court with respect to the earlier Tax Court decision in this case was

that the Dunlap partners had made a down payment on the property and the Hilton partners had not. 74 T.C. at 1437. The irrelevance of the down payment issue has been discussed above. Moreover, as the Tax Court itself recognized in **Bolger v. Commissioner,** 59 T.C. 760 (1973), an investment in property sufficient to justify depreciation deductions occurs when rental income is applied to principal, even though no down payment is made. In the present case, the Petitioners are acquiring an ownership interest in the property by virtue of the application of the lease payments to principal, and the lack of a down payment is irrelevant. Moreover, even an investor who makes a down payment can do so by borrowing the funds. Finally, the four percent down payment in **Dunlap** is hardly of significant magnitude.

It is apparent that the Tax Court should have reached the same result in the present case and in **Dunlap.** Moreover, the Tax Court should not have found **Lyon** to be distinguishable from the present case if **Lyon** was applicable in **Dunlap.** The Ninth Circuit had the opportunity herein to correct this inconsistency, but failed to do so.Not only are the present Petitioners prejudiced by such inconsistent treatment, but numerous other taxpayers - businesses, insurance companies, and individuals - are unable to plan their sale-leaseback transactions with any degree of certainty as to the federal income tax results. Sale-leasebacks are a fact of commercial life, as are the effects of the federal income tax laws on the structuring of such transactions. This Court should grant this petition

for a writ of certiorari not only to prevent injustice to the Petitioners herein, but also to secure uniformity and certainty in the administration of the federal income tax laws by reaffirming that the tests expressed in the **Lyon** opinion are applicable to the type of sale-leaseback transaction involved herein.

CONCLUSION

For the foregoing reasons, a writ of certiorari should issue to review the judgment and opinion of the United States Court of Appeals for the Ninth Circuit and the United States Tax Court.

Dated: July 27, 1982

Respectfully submitted,

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PROOF OF SERVICE

STATE OF CALIFORNIA)
) ss.
COUNTY OF RIVERSIDE)

I am a citizen of the United States and a resident of the County aforesaid; I am over the age of eighteen years and not a party to the within entitled action; my business address is 4075 Agate Street, Riverside, California 92509.

On July _____ , I served the within PETITION FOR WRIT OF CERTIORARI on the interested parties in said action, by placing a true copy in each of two (2) sealed envelopes, with postage thereon fully prepaid, in the United States mail at San Berardino, California, addressed as follows:

Mrs. John F. Murray
Acting Ass't
Attorney General
Tax Division
U.S. Dept. of Justice
Attention: Michael L. Paup
Chief Appellate Section
Washington, D.C. 20530

Solicitor General
Department of Justice
Washington, D.C. 20530

I certify under penalty of perjury that the foregoing is true and correct.

EXECUTED on July _____ , at San Bernardino, California.

_____
JACK GALLAGHER